Securities Industry Association

120 Broadway, New York, NY 10271-0080, (212) 608-1500, Fax (212) 608-1604
1401 Eye Street, NW, Washington, DC 20005-2225, (202) 296-9410, Fax (202) 296-9775
info@sia.com, http://www.sia.com

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Ms. Joan Conley
Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Dear Ms. Conley:

The Securities Industry Association ("SIA") [1] and its *Ad Hoc* Committee ("Committee") reviewing the National Association of Securities Dealers, Inc. ("NASD") Notice To Members 96-59 [2] are writing to express our concerns regarding the NASD Regulation, Inc. ("NASDR") proposed rule governing tape recording of telephone conversations. Although we agree with the objective of the proposed rule, we believe there are less intrusive and more effective means available to rid the industry of registered representatives and firms that engage in sales practice abuses. As proposed, if more than 20 percent of a member firm's associated persons previously were employed by a "disciplined member firm," or if the member itself is a "disciplined firm," the member would be required to tape record all telephone conversations between all of its associated persons and both existing and potential customers. The rule also would require firms subject to the taping requirement to review the tapes periodically to ensure compliance with securities laws and NASD rules, to submit reports to the NASD on their supervision of telemarketing activities, and to retain and index the tapes.

I. Overview of the Proposed Rule

The SIA is committed to combating sales practice abuse and removing from the industry those individuals as well as firms that engage in such practices. The SIA Board of Directors has unanimously endorsed the recommendations in the Joint Regulatory Sales Practice Sweep Report ("Sweep Report") [3] to augment current regulations and securities firm procedures governing the hiring and supervision of registered representatives. [4] The SIA's top priority is promoting trust and confidence in our markets. The public's confidence in the integrity of the marketplace is essential to our industry's existence.

According to the Notice To Members, the proposed rule is NASDR's response to concerns expressed in the Sweep Report regarding the need for heightened supervision of certain registered representatives with troubled regulatory and compliance records. One of the key findings of the Sweep Report was that some firms are willing to employ registered representatives with a history of disciplinary actions or customer complaints.

The Committee strongly supports the concept of heightened supervision for certain registered representatives. The unfettered ability to listen in on private communications, including those of third parties and registered representatives who have never been the subject of any regulatory action, however, is over-reaching and destructive of the privacy rights and reputations of individuals who have done no wrong. Furthermore, such measures are unnecessary, given that less intrusive measures than taping are available to meet our shared goal.

The Sweep Report states that "[F]irms that hire registered persons that have a history or pattern of customer complaints, disciplinary actions, or arbitrations are responsible for imposing close supervision *over these persons*. 'Normal' supervision is simply not enough; firms must craft special supervisory procedures *tailored to the individual representative*." (Emphasis added.) The Committee believes that individualized supervision, as described in the Sweep Report, is far superior to the approach proposed in Notice To Members 96-59, where guilt by association can affect registered representatives who are themselves not subject to any regulatory sanctions or scrutiny concerning their personal selling activities. Individualized supervision would allow the firm to develop procedures tailored to the particular product or practice that gave rise to the heightened supervision.

Moreover, the Sweep Report states that "[I]f firms fail to establish such special supervisory procedures, SROs will consider whether it is necessary to amend their rules to specifically require these registered representatives to be placed under special supervision by the firm for a period of time." Many firms have devoted considerable resources toward continuing efforts to improve compliance systems, to implement stronger procedures to protect customers, and to identify and keep bad brokers out of their firms. The Committee believes, therefore, that there is no basis for the current sweeping proposal. Indeed, the NASDR has not cited any evidence that firms have failed to establish special supervisory procedures where warranted. (And if any instances have occurred, they should be dealt with by NASDR on an individualized basis.) The Committee also believes that the heightened supervision contemplated in the Sweep Report is more akin to that required when an SRO approves the association with a member firm of an individual subject to a statutory disqualification. In such a case, the supervision is tailored to the individual rather than to the firm.

II. Specific Problems Associated with the Taping Requirement

A. Taping Does Not and Should Not Equate to Supervision

The Committee believes that taping telephone conversations between sales personnel and clients should not be elevated to, or equated with, supervision. [5] Rather, effective supervision involves being proactive and establishing policies and procedures designed to deter abusive practices. Furthermore, the reactive type of supervision proposed here, *i.e.*, scrutinizing conversations conducted in the ordinary course of business after the fact, is not an efficient use of limited resources by compliance and/or supervisory personnel. Instead, firms should be encouraged to develop reasonable supervisory procedures appropriate for their size, structure, and the nature of their business. The philosophy underlying self-regulation has always been to give firms the flexibility to determine reasonable standards for supervision rather than to dictate specific mandatory procedures as set out in this proposal. [6]

The Committee believes that regulators should be judicious in establishing specific standards or

procedures because they quickly become the standard to which all firms are held. It would be unfortunate if this proposed rule established the notion that, at a minimum, adequate supervisory procedures include the comprehensive taping of telephone calls.

The Committee does not dispute that in certain isolated cases tape recording sales calls may be appropriate. For example, this practice was recommended by an Independent Auditor whose review and recommendations were the result of a consent decree with the SEC. [7] That case, however, involved findings by the SEC that the firm had engaged in fraudulent sales practices, made baseless price predictions, made material misrepresentations concerning securities and the firm's experience and expertise, engaged in, encouraged, and/or permitted unauthorized trading in customer accounts, and knowingly or recklessly manipulated the market price of a particular stock. In such a case, tape recording is an appropriate remedy. NASDR, however, would damage the entire industry by imposing such a draconian measure on the large number of firms that would fall within the definition of disciplined firm.

Tape recording should be reserved for the most egregious crimes and should not be used as a prophylactic measure to replace SRO enforcement. The Committee acknowledges the difficult problems that NASDR is attempting to address, *e.g.*, under some circumstances, shutting down an offending firm simply causes the sales personnel to move to other firms that previously had clean records. Nevertheless, the Committee believes that NASDR should use the disciplinary process to rid the industry of these registered representatives. A pervasive scheme of taping where innocent registered representatives can be discredited because of their prior affiliation with a disciplined firm violates basic notions of fairness.

B. Unintended Collateral Consequences of "Disciplined Firm" Categorization

The categorization of a firm as a "disciplined firm" creates a separate fundamental problem. The Notice states that NASDR will assist firms in complying with the rule by compiling and maintaining a list of firms that meet the definition of "disciplined firm." To the extent that this information is accessible by the public, such categorization could have unforeseen and unintended collateral consequences in terms of adverse litigation, other regulatory ramifications, etc. Creating, in effect, a "B" list of firms simply invites the misleading of the public and misuse of this information by third parties. This is not to say the Committee is attempting to shield problem firms. Indeed, we believe that, where warranted by evidence, firms that systematically engage in serious sales practice abuses should be put out of business.

Also, while we do not believe that drafting modifications can cure the proposal, there are fundamental problems with certain defined terms. For example, the definition of "disciplined firm" could be read broadly to include any firm that has ever been the subject of a disciplinary proceeding. If, indeed, NASDR is targeting a "not insignificant but not-very-large" number of firms, [8] the definition should be clarified. It is not clear, for example, whether the language "in connection with telemarketing or sales practices involving the offer, purchase, or sale of any security" is intended to limit the verb phrases that follow. Arguably, the "in connection with the purchase or sale of any security" language at the end of the sentence could be read to modify the verb phrases that precede it.

The proposed rule also goes beyond registered representatives, the group for which it was designed, and applies to all "associated persons." Clerical and operations staff, therefore, also

would have their telephone calls monitored. In addition, any such support staff that had been employed by a disciplined firm would count toward the 20 percent. This means that a firm could be required to tape record calls despite the fact that no significant percentage of its sales force came from a disciplined firm. All employees who had been employed by a disciplined firm could have difficulty finding subsequent employment because firms justifiably would be reluctant to hire them for fear of triggering the taping requirements.

Moreover, the proposal would have a disproportionate impact on small firms. The fewer associated persons a firm employs, the easier it will be to reach the 20 percent threshhold and trigger the taping requirement. The costs of installing, maintaining, and managing such a system, while considerable for any firm, would be prohibitive for small firms, which would not have the economies of scale available to larger firms in designing and implementing such a system.

III. The Taping Requirement Offends a Fundamental Principle of American Liberty

The tape recording involved in the proposal by NASDR is, to be blunt, a massive invasion of privacy of potentially thousands of registered representatives, as well as their families, friends, and associates, and millions of public customers. The practice of tape recording conflicts with our traditions, statutes, and Constitution, and its use as an enforcement tool simply does not justify the extraordinary diminution of privacy that it entails.

This aversion to eavesdropping is illustrated by the debates surrounding the federal law that authorizes wiretapping by the government in certain circumstances, as well as by the protections written into that law. Wiretapping or tape recording when done under color of law is very limited and has numerous procedural requirements to protect against overreaching and abuse. [9] The legislative history to Title III, "Wiretapping and Electronic Surveillance," part of the Omnibus Crime Control and Safe Streets Act of 1968, [10] makes clear that the major purpose of the provision permitting wiretapping is to combat organized crime. Before signing the legislation in 1968, President Johnson, the Attorney General, and some members of Congress argued that wiretapping was such a drastic and constitutionally questionable remedy that it should be limited further still. [11]

Even in those rare cases where the benefits of tape recording have been perceived to outweigh privacy concerns, there has been careful consideration of those concerns in structuring a system to monitor and record telephone conversations. For example, in a recent settlement agreement with 24 major securities firms, the Department of Justice took the unprecedented step of requiring the firms to randomly tape record and monitor traders' telephone calls to ensure that their traders do not engage in certain anti-competitive practices including participation in a quoting convention whereby market makers quote prices in Nasdaq securities with a spread of three quarters or more in quarters rather than eighths. The order, however, is carefully tailored to limit the recording (and monitoring) to not less than 3 1/2 percent of the total number of trader hours, not to exceed 70 hours per week. In addition, tapes made pursuant to the order need only be retained for 30 days from the date of recording and can be recycled thereafter. Moreover, the tapes are not discoverable except by the Department of Justice, the Securities and Exchange Commission, or a self-regulatory organization. The NASDR proposal, on the other hand, requires taping and monitoring of all calls, requires that they be preserved for three years, and contains no assurance that the tapes would not be discoverable by third

parties for use in litigation.

The Committee is particularly concerned about the accessibility and the appropriate use of the tapes. It is expected that once such a system is in place, tapes would be routinely requested for use in arbitration, litigation, and to resolve routine customer complaints. At a minimum, this would expand dramatically the liability of supervisors and compliance personnel who are charged with monitoring the recordings.

IV. Alternative Approaches

The Committee shares the commitment of NASDR to deter abusive sales practices and wants to work with NASDR to address effectively the vexing problem of ridding the industry of registered representatives and firms that engage in such practices. The Committee believes that there are less intrusive and much more effective means available for dealing with this problem than the taping requirement proposed in Notice To Members 96-59.

As discussed above, the SIA has endorsed the Sweep Report recommendation regarding more stringent hiring procedures. Moreover, immunity for statements made on the Form U-5 would ensure full and frank disclosure, which also would serve to keep unscrupulous registered representatives out of the business. NASDR should pursue this goal. The SIA also endorsed, and the Committee fully supports, heightened supervision tailored to the individual for those registered representatives with a "history" of disciplinary actions. NASDR also might consider special continuing education requirements for certain registered representatives. Additionally, requalification for registered representatives with a "history" of disciplinary actions should become a minimum requirement under NASDR sanction guidelines.

The Committee believes that all SIA member firms are anxious to explore new and better supervisory methods for detecting and deterring sales practice abuses. However, the tape recording requirement proposed in Notice To Members 96-59 will not accomplish that objective. Better, more effective methods are available for addressing the problem. In fact, many firms have committed substantial resources to enhancing supervisory systems and these initiatives should be given an opportunity to work before a sweeping measure such as that proposed is considered. Additionally, regulators should step up their efforts through the disciplinary process to eliminate from the industry those registered representatives who engage in sales practice abuses.

Thank you for the opportunity to comment. Given the significance and far-reaching impact of this proposal, we would appreciate the opportunity to meet with appropriate staff to discuss our views in more detail. If you have any questions, please contact the undersigned or Judith Poppalardo, Assistant Vice President and Assistant General Counsel, at (202) 296-9410.

Sincerely,

Richard O. Scribner
Chairman Self-Regulation and Supervisory Practices Committee

C. Evan Stewart
Chairman Federal Regulation Committee

Allen B. Holeman

President Compliance and Legal Division

Footnotes

[1] The Securities Industry Association ("SIA") is the trade association representing the business interests of about 750 securities firms in North America. Its members include securities organizations of virtually all types - investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for 90% of securities firm revenue in the United States.

[2] The *Ad Hoc* Committee, composed of representatives from the Self-Regulation and Supervisory Practices and Federal Regulation Committees, and the Compliance and Legal Division, was formed specifically to formulate an industry response to this proposal.

[3] The Joint Regulatory Sales Practice Sweep was a coordinated effort undertaken by the staffs of the NASD, the New York Stock Exchange ("NYSE"), the Securities and Exchange Commission ("SEC"), and representatives of the North American Securities Administrators Association ("NASAA") to review the sales practice activities of selected registered representatives and the hiring, retention, and supervisory practices of the firms employing them. The Joint Regulatory Sales Practice Sweep Report was issued in March 1996.

[4] Recommendations directed to firms included adopting stringent hiring practices, heightening supervision for certain registered representatives, tying a component of a branch office manager's compensation to effective supervision, and training and supervising cold-callers to ensure compliance with relevant federal and self-regulatory organization ("SRO") rules.

[5] The Committee acknowledges that many firms routinely tape record telephone calls with customers. However, it is done principally to resolve trade disputes and not for purposes of supervision. Calls may or may not be monitored, do not need to be stored for extensive periods of time, nor is a comprehensive indexing system necessary. These aspects of the proposal undoubtedly will make it expensive to implement. This burden is unjustified without a showing that taping is an appropriate measure to curb the abuses cited.

[6] This approach has been extremely successful in the context of Chinese Wall procedures. In 1991, the NYSE and NASD recognized that there is no single appropriate standard and directed firms to develop appropriate procedures to prevent the flow of material, non-public information within their firms. See NASD/NYSE Joint Memorandum on Chinese Wall Policies and Procedures, June 21, 1991, NYSE Information Memo #91-22, June 28, 1991. The NYSE has adopted a similar approach in proposed amendments that were filed with the SEC on September 12, 1996 regarding supervision of communications with the public (SR-NYSE-96-26).

[7] Stratton Oakmont, Inc., Exchange Act Release No. 33,778, 1994 WL 91289 (March 17, 1994).

[8] Deborah Lohse, NASD Proposal Would Require Taping All Broker Sales Calls at Some Firms, Wall St. J., September 23, 1996.

[9] The Omnibus Crime Control and Safe Streets Act of 1968 requires, among other things:

- detailed probable cause demonstrations to an appropriate judicial authority;
- restraint on any judicial authorization of eavesdropping for any period longer than is necessary to achieve the objective of the authorization, or in any event longer than thirty days;
- a conclusion by the authorizing judge that "normal investigative procedures" have been tried and have failed or reasonably appear to be unlikely to succeed or too dangerous; and
- that any order authorizing interceptions be conducted in such a way as to minimize the interception of communications not otherwise subject to interception under the provision. Public L. No. 90-351, Section 802 (codified at 18 U.S.C. 2516).

[10] Id.

[11] S. Rep. No. 1097, 90th Cong., 2d Sess. ___, reprinted in 1968 U.S.C.C.A.N. 2112, 2209-73.